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**Dan Ozizmir
Swiss Re Financial Products Corp.**

The Risk-Linked Securities Market

I would like to thank Chairwoman Kelly and Chairman Oxley for holding this hearing on the risk-linked securities market, an important and growing segment of the fixed-income and reinsurance markets. My name is Dan Ozizmir. I am a Senior Managing Director and Head of Trading with Swiss Re Financial Products, a subsidiary of Swiss Re, the largest reinsurer in North America and the second largest in the world. Swiss Re is also a member of the Reinsurance Association of America.

Swiss Re has been a leader in the risk-linked securities market, creating Swiss Re Capital Markets Corporation to develop the market and, in 1997, sponsoring one of the first risk-linked securities transactions, SR Earthquake Ltd.

Swiss Re has an interest in this market from two primary perspectives:

- We structure and underwrite new risk-linked securities issues, and
- We access the risk-linked securities market as an alternative source of capital.

My comments will focus on the current state and possible future direction of the risk-linked securities market from each of these perspectives by briefly answering:

- What motivates insurers and investors to participate in this market?
- What is the current and future direction of the risk-linked securities market?

Please note that we are a member of the Bond Market Association, which is also presenting today. We have had a chance to review their testimony and have tried to avoid duplication. Note that we generally agree with the Bond Market Association's statement; however, we do differ slightly on where to focus to further develop the market. For example, we believe investor education and product innovation will have the greatest impact on the success of this market.

Insurer Motivation

Consider a primary insurer that writes California homeowner's insurance and wants to provide

insurance coverage against losses resulting from earthquakes. The insurer, not to mention regulators and policyholders, want to make sure it can pay its claims after a major earthquake. It can do so using several basic tools:

- Raising more equity capital by selling more company stock ;
- Transferring risks to the reinsurance markets (effectively, increasing its capital base); and
- Limiting risks via the underwriting and asset management process.

While not a perfect substitute for any of these approaches, transferring risks to the risk-linked securities market is a useful fixed cost multi-year complement to these other tools for certain peak catastrophe risks to the insurance industry, such as East Coast hurricanes and California earthquakes. It can help stabilize and even lower the cost of capital.

(As an aside, an insurer needs to hold significantly more equity to underwrite peak exposures, like a Florida hurricane or California earthquake than it does to underwrite non-peak exposures such as a single house fire or auto accident. In fact, equity is an extremely efficient source of capital for non-peak exposures as we can use the same dollar of capital to underwrite many dollars of coverage.)

The lower the cost of capital to insurers, the greater the availability of affordable insurance to policyholders. Making affordable insurance more available has important public policy implications. For example, as of the end of 2001, only 17% of California homeowners had earthquake insurance. Presumably, if earthquake coverage were less expensive, more consumers would obtain coverage. This in turn would reduce the potential burden on the government to provide emergency disaster relief following a major catastrophe. We note, however, that the limited availability of affordable coverage is not the only reason homeowners remain uninsured. In addition, policyholders may not like the terms of the policy (e.g., it has a high deductible) or they may have been conditioned that the government will provide disaster relief if they are uninsured.

The GAO report suggests that the potential for “basis risk”, the difference between actual losses and losses covered in the risk-linked securities may present an obstacle to the development of the RLS market. Basis risk may exist because in most risk-linked securities transactions, recoveries depend on transparent triggers such as an industry index or a formula based on physical parameters from a hurricane or earthquake rather than on actual losses to the sponsoring entity. Note that various techniques exist to mitigate the impact of basis risk. For example, professional reinsurers such as Swiss Re can provide reinsurance coverage to mitigate the difference between actual losses and recovery under the risk-linked security. Further, to the extent the primary goal of a securitization is to provide capital relief, the retention of basis risk is less problematic. An insurer will receive significant capital relief for a transaction even where it retains basis risk.

Investor Motivation

Fixed income or bond investors buy risk-linked securities (known to them as “cat bonds”) to diversify their investment portfolios. Adding risk-linked securities to a fixed income portfolio reduces the expected standard deviation for the portfolio, improving the portfolio’s overall risk-return profile. In other words, the return stays the same but the portfolio risk goes down. This occurs because defaults on corporate bonds and natural disasters are not correlated. As an example, historically there has been essentially no relationship between an earthquake in Tokyo and the default of a corporate bond issued by a U.S. issuer.

Given these diversification benefits, an obvious question is why have many significant fund investors stayed on the sidelines. We believe fund investors have stayed on the sidelines for three primary reasons.

First, before investing in the sector, investors need to take time to understand risk-linked securities. In general they are only willing to do so, if they believe the market is large enough and offers sufficient benefits to make it worth doing.

Second, some investors are under the misimpression that risk-linked securities default in a way that makes it difficult to trade out of the bonds and suffer a partial loss. As an example, even as Hurricane Lili approached the Gulf Coast last week, we continued to trade the potentially affected bonds. And, by the way, it is also not true that an investor can always trade out of a deteriorating corporate bond prior to default.

Finally, some fund managers believe that investing risk-linked securities has a “career” risk for them. In contrast to a risk-linked securities default, if a manager loses money on a debt from a large corporate issuer, the manager can point to his or her many peers who suffered the same loss. There is safety in numbers.

Continued growth in the risk-linked securities market depends on increasing numbers of investment managers concluding that the diversification benefits outweigh these three concerns.

The Risk-Linked Securities Market: Current Status and Future Directions

At present, for our company, risk-linked securities represent a relatively small but strategically important source of capital. For us and for the industry as a whole, however, the other tools mentioned above -- equity, reinsurance, and controlling risk -- are much more important. At present, we believe that while some lower rated insurers and reinsurers might face capital strain from the equivalent of two natural catastrophes on the order of a Hurricane Andrews, the industry as a whole remains capable of meeting its obligations. Note that notwithstanding the estimated insured losses from the September 11th attacks, which are greater than Hurricane Andrew and the Northridge Earthquake combined, reinsurance remains readily available. (A major exception to this rule is terrorism coverage that is either not available or extremely expensive.)

However, prices in many lines have increased, in large part due to the inadequate pricing

environment preceding both 9/11 and the equity market decline of the last several years. In our view, risk-linked securities are important in assuring the continued availability of affordable insurance to policyholders in areas exposed to peak perils such as East Coast hurricanes and California earthquakes. Stated differently, in the absence of a viable risk-linked securities market, the number of uninsured policyholders in areas exposed to peak perils could increase, in some cases substantially. On the other hand, growth in the risk-linked securities market could cause coverage to expand.

As alluded to previously, our view is that the primary obstacle to growth in the risk-linked securities market is the limited participation of large money managers in the US and Europe as investors. It is important to note that generally, rating agencies, insurance regulators, and other government entities rather than being obstacles to growth have been in fact quite supportive of the development of this market.

On the whole, we expect the risk-linked securities market to continue to grow in several ways. First, we would anticipate the absolute amount of securities outstanding to continue to grow as new investors begin to participate and existing investors devote more capital to the sector. Second, we anticipate that over time innovation will gradually broaden the types of risks securitized. On this second point, I would note in particular that the risk-linked securities market is **not** a near term solution for providing capacity for terrorism risk. Today terrorism risk cannot be quantified. We believe that the only solution to this important and difficult problem is passage of a government backstop.

Conclusion

In conclusion, we believe that the risk-linked securities market plays a useful role in providing an additional source of capital to the reinsurance and insurance industry and hope that it will continue to do so over time. To the extent that it succeeds in doing so, it can help increase the availability of affordable insurance to policyholders exposed to peak perils and, therefore, reduce the amount of uninsured losses from natural catastrophes.